

Exhibit 5
Demonstration of Financial Fitness to Undertake Proposed Services

INDEX TO FINANCIAL STATEMENTS

	<u>page</u>
Report of Arthur Andersen LLP, Independent Public Accountants	F-2
Balance Sheets	F-3
Statements of Operations	F-5
Statements of Changes in Stockholders' Equity (Deficit)	F-6
Statements of Cash Flows	F-7
Notes to Financial Statements	F-8

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

Pac-West Telecomm, Inc.

To the Board of Directors and Stockholders
of Pac-West Telecomm, Inc.:

We have audited the accompanying balance sheets of Pac-West Telecomm, Inc. (a California corporation) as of December 31, 1998 and 1999, and the related statements of operations, changes in stockholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Pac-West Telecomm, Inc. as of December 31, 1998 and 1999, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States.

Arthur Andersen LLP

San Francisco, California,
February 10, 2000

Balance Sheets (as of December 31, 1998 and 1999)

ASSETS

	1998	1999
Current Assets:		
Cash and cash equivalents	\$ 15,236,000	\$ 82,688,000
Restricted cash	—	10,087,000
Short-term investments	—	70,138,000
Trade accounts receivable, net of allowances of \$400,000 and \$675,000 in 1998 and 1999, respectively	4,623,000	8,339,000
Accounts receivable from related parties	64,000	63,000
Income tax receivable	1,971,000	195,000
Inventories	447,000	952,000
Prepaid expenses and other current assets	861,000	2,786,000
Deferred financing costs, net	457,000	864,000
Deferred tax assets	151,000	580,000
Total current assets	<u>23,810,000</u>	<u>176,692,000</u>
Equipment, Vehicles and Leasehold Improvements:		
Network and other communication equipment	29,817,000	71,142,000
Office furniture and equipment	1,965,000	3,640,000
Vehicles	717,000	1,199,000
Leasehold improvements	5,581,000	11,661,000
Projects in progress (Note 2)	25,597,000	32,405,000
	<u>63,677,000</u>	<u>120,047,000</u>
Less: Accumulated depreciation and amortization	(6,383,000)	(14,858,000)
Equipment, vehicles and leasehold improvements, net	<u>57,294,000</u>	<u>105,189,000</u>
Other Assets, net	1,389,000	8,219,000
Total assets	<u>\$ 82,493,000</u>	<u>\$ 290,100,000</u>

The accompanying notes are an integral part of these financial statements.

Balance Sheets (as of December 31, 1998 and 1999)

LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)

	1998	1999
Current Liabilities:		
Current portion of notes payable	\$ 132,000	\$ 99,000
Accounts payable	5,147,000	13,158,000
Accrued payroll and related expenses	846,000	1,719,000
Accrued interest on Senior Notes	—	8,435,000
Other accrued liabilities	2,153,000	1,269,000
Income taxes payable	—	520,000
Total current liabilities	<u>8,278,000</u>	<u>25,200,000</u>
Senior Notes	—	150,000,000
Senior Secured Borrowings and Other Long-Term Obligations (Note 3)	100,000,000	—
Notes Payable , less current portion	116,000	17,000
Total long-term debt	<u>100,116,000</u>	<u>150,017,000</u>
Deferred Income Taxes	1,888,000	8,633,000
Total liabilities	<u>110,282,000</u>	<u>183,850,000</u>
Commitments and Contingencies (Note 5)		
Convertible Redeemable Preferred Stock , \$0.001 par value; 1,750,000 shares authorized; 1,750,000 and 0 issued and outstanding at December 31, 1998 and 1999, respectively (preference in liquidation of \$45,000,000, plus accrued cumulative dividends of \$1,324,000 at December 31, 1998)	46,324,000	—
Stockholders Equity (Deficit):		
Common stock, \$0.001 par value:		
Authorized shares—50,000,000		
Issued and outstanding shares—17,587,458 and 35,393,326 at December 31, 1998 and 1999, respectively	18,000	35,000
Additional paid-in capital	8,905,000	173,345,000
Notes receivable from stockholders	(233,000)	(233,000)
Retained earnings (deficit)	(82,803,000)	(66,897,000)
Total stockholders' equity (deficit)	<u>(74,113,000)</u>	<u>106,250,000</u>
Total liabilities and stockholders' equity (deficit)	<u>\$ 82,493,000</u>	<u>\$ 290,100,000</u>

The accompanying notes are an integral part of these financial statements.

Statements of Operations (for the years ended December 31, 1997, 1998 and 1999)

	1997	1998	1999
Revenues (Note 5)	\$ 29,551,000	\$42,211,000	\$ 95,505,000
Costs and Expenses:			
Operating	12,060,000	15,344,000	20,510,000
Selling, general and administrative:			
Selling, general and administrative	7,367,000	10,779,000	22,855,000
Transaction bonuses and consultant's costs (Note 1)	—	3,798,000	—
Depreciation and amortization	2,204,000	4,106,000	8,689,000
Total costs and expenses	21,631,000	34,027,000	52,054,000
Income from operations	7,920,000	8,184,000	43,451,000
Other Expense (Income):			
Interest expense	932,000	4,199,000	18,124,000
Gain on disposal of answering service division	(385,000)	—	—
Costs of merger with PWT Acquisition Corp. and recapitalization	—	3,004,000	—
Other income, net	(119,000)	(330,000)	(3,690,000)
Total other expense, net	428,000	6,873,000	14,434,000
Income before provision for income taxes and extraordinary item	7,492,000	1,311,000	29,017,000
Provision for Income Taxes	2,997,000	1,561,000	13,111,000
Income (loss) before extraordinary item	4,495,000	(250,000)	15,906,000
Extraordinary Item:			
Loss on early extinguishment of debt, net of income tax benefit of \$278,000	—	(417,000)	—
Net income (loss)	4,495,000	(667,000)	15,906,000
Accrued Preferred Stock Dividends	—	(1,324,000)	(4,085,000)
Net Income (Loss) Applicable to Common Stockholders	\$ 4,495,000	\$ (1,991,000)	\$ 11,821,000
Income (Loss) Before Extraordinary Item Per Share:			
Basic	\$ 32.11	\$ (0.30)	\$ 0.59
Diluted	\$ 32.11	\$ (0.30)	\$ 0.56
Net Income (Loss) Per Share:			
Basic	\$ 32.11	\$ (0.38)	\$ 0.59
Diluted	\$ 32.11	\$ (0.38)	\$ 0.56
Weighted Average Shares Outstanding:			
Basic	140,000	5,244,191	20,172,968
Diluted	140,000	5,244,191	21,293,828

The accompanying notes are an integral part of these financial statements.

Statements of Changes in Stockholders' Equity (Deficit)

FOR THE YEARS ENDED DECEMBER 31, 1997, 1998 AND 1999

	Common Stock		Additional	Notes	Retained	Total
	Shares	Amount	Paid-in	Receivable	Earnings	Stockholders
			Capital	from	(Deficit)	Equity
				Stockholders		(Deficit)
BALANCE, December 31, 1996	140,000	\$ 4,037,000	\$ —	\$ —	\$ 140,000	\$ 4,177,000
Net income	—	—	—	—	4,495,000	4,495,000
BALANCE, December 31, 1997	140,000	4,037,000	—	—	4,635,000	8,672,000
Conversion to \$0.001 par value stock	—	(4,037,000)	4,037,000	—	—	—
Effect of merger with PWT Acquisition Corp. and recapitalization (Note 1)	7,176,988	7,000	1,193,000	—	(86,771,000)	(85,571,000)
Issuance of common stock	9,658,012	10,000	4,708,000	—	—	4,718,000
Accrued cumulative dividends— preferred stock	—	—	(1,324,000)	—	—	(1,324,000)
Issuances of common stock for cash and notes receivable	612,458	1,000	291,000	(233,000)	—	59,000
Net loss	—	—	—	—	(667,000)	(667,000)
BALANCE, December 31, 1998	17,587,458	18,000	8,905,000	(233,000)	(82,803,000)	(74,113,000)
Net proceeds from initial public offering of common stock	12,765,000	12,000	118,121,000	—	—	118,133,000
Conversion of preferred stock	5,040,868	5,000	50,404,000	—	—	50,409,000
Accrued cumulative dividends— preferred stock	—	—	(4,085,000)	—	—	(4,085,000)
Net income	—	—	—	—	15,906,000	15,906,000
BALANCE, December 31, 1999	35,393,326	\$ 35,000	\$173,345,000	\$ (233,000)	\$166,897,000	\$106,250,000

The accompanying notes are an integral part of these financial statements.

Statements of Cash Flows

FOR THE YEARS ENDED DECEMBER 31, 1997, 1998 AND 1999

	1997	1998	1999
Operating Activities:			
Net income (loss)	\$ 4,495,000	\$ (667,000)	\$ 15,906,000
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Extraordinary item—loss on early extinguishment of debt, net of income tax benefit	—	417,000	—
Costs of merger with PWT Acquisition Corp. and recapitalization	—	3,004,000	—
Depreciation and amortization	2,204,000	4,106,000	8,689,000
Amortization of deferred financing costs	—	1,438,000	1,162,000
Gain on disposal of answering service division	(385,000)	—	—
Gain on disposal of equipment	(15,000)	—	—
Interest earned on restricted cash	—	—	(629,000)
Provision for doubtful accounts	216,000	100,000	275,000
Deferred income tax provision	711,000	963,000	6,316,000
Changes in operating assets and liabilities:			
Increase in trade accounts receivable	(2,034,000)	(1,061,000)	(3,991,000)
Decrease (increase) in accounts receivable from related parties	(67,000)	97,000	1,000
Decrease (increase) in income tax receivable	0	(1,971,000)	1,776,000
(Increase) decrease in inventories	195,000	(117,000)	(505,000)
Increase in prepaid expenses and other current assets	(175,000)	(263,000)	(1,975,000)
Decrease (increase) in other assets	(56,000)	91,000	(2,541,000)
Increase in accounts payable	654,000	3,988,000	8,011,000
Increase in accrued interest on Senior Notes	—	—	8,435,000
Increase in income taxes payable	—	—	520,000
Increase (decrease) in accrued payroll and related expenses and other liabilities	133,000	1,908,000	(11,000)
Net cash provided by operating activities	5,876,000	12,033,000	41,439,000
Investing Activities:			
Purchases of equipment, vehicles and leasehold improvements	(7,103,000)	(42,176,000)	(56,370,000)
Purchases of short-term investments	—	—	(70,138,000)
Purchase of restricted cash investments, net of redemptions of \$10,238,000	—	—	(9,458,000)
Proceeds from disposal of answering service division	402,000	—	—
Proceeds from disposal of equipment	82,000	145,000	—
Net cash used in investing activities	(6,619,000)	(42,031,000)	(135,966,000)
Financing Activities:			
Proceeds from issuance of Senior Notes	—	—	150,000,000
Net proceeds from initial public offering of common stock	—	—	118,133,000
Repayment of senior secured borrowings	—	—	(100,000,000)
Proceeds from notes payable	5,931,000	10,514,000	—
Repayments on notes payable	(1,332,000)	(2,658,000)	(132,000)
Principal payments on capital leases	(730,000)	(828,000)	—
Payment for deferred financing costs	—	(1,195,000)	(6,022,000)
Proceeds from senior secured borrowings	—	15,587,000	—
Increase in other long-term obligations	—	9,000,000	—
Proceeds from the issuance of common stock	—	9,000	—
Merger with PWT Acquisition Corp. and recapitalization:			
Proceeds from the issuance of preferred stock	—	31,844,000	—
Proceeds from the issuances of common stock	—	5,968,000	—
Proceeds from senior secured borrowings	—	75,413,000	—
Payments to existing stockholders	—	(74,015,000)	—
Extinguishments of notes payable and capital leases	—	(23,159,000)	—
Payment for deferred financing costs	—	(1,895,000)	—
Costs of merger with PWT Acquisition Corp. and recapitalization	—	(2,954,000)	—
Repayment of loans payable to officers and stockholder	(211,000)	—	—
Net cash provided by financing activities	3,658,000	41,631,000	161,979,000
Net increase in cash and cash equivalents	2,915,000	11,633,000	67,452,000
Cash And Cash Equivalents:			
Beginning of year	688,000	3,603,000	15,236,000
End of year	\$ 3,603,000	\$ 15,236,000	\$ 82,688,000

The accompanying notes are an integral part of these financial statements.

NOTES TO FINANCIAL STATEMENTS

ITEM 1. ORGANIZATION

Pac-West Telecomm, Inc. (the Company) is a rapidly growing provider of integrated communications services in the western United States. The Company's customers include Internet Service Providers (ISPs), small and medium businesses and enhanced communications service providers, many of which are communications intensive users.

The Company was incorporated in May 1996 in the state of California as a wholly owned subsidiary of CalPage (a telephone, answering and paging services company), also formerly named Pac-West Telecomm, Inc. CalPage transferred its telephone and answering service divisions to the Company effective September 30, 1996 (the Initial Transfer).

During 1997, the Company sold the customer base and other assets of its answering service division (see Note 10).

The success of the Company is dependent upon several factors. These factors include the Company's ability to penetrate additional markets and to manage network growth and technological change within the telecommunications industry, the successful implementation of local and enhanced services to its customers and ISPs, and competition from preexisting and new providers of local and long-distance services, as well as positive and timely responses regarding governmental regulations.

On September 16, 1998, the Company completed a merger with PWT Acquisition Corp. (PWT) and a recapitalization of the Company (the Transaction). PWT was formed by a group of investors (the New Stockholders) for the purpose of injecting additional equity into the Company and effecting the recapitalization. In connection with the Transaction, PWT was merged into the Company, with the Company being the surviving corporation. In connection with the Transaction, the existing stockholders of the Company received cash payments of approximately \$74 million, as well as shares of newly issued preferred and common stock of the Company in exchange for a substantial portion of their ownership interests. Additionally, at the consummation of the Transaction, the Company paid transaction bonuses and consultant's costs totaling approximately \$3.8 million, which are included in the accompanying statements of operations. Under the terms of the Transaction, the existing stockholders of the Company were entitled to receive additional consideration up to \$20 million in the event that certain billings under dispute were received subsequent to the recapitalization (see Note 5). After consummation of the Transaction, the existing stockholders continue to hold approximately 28 percent of the issued and outstanding common stock of the Company. As a result of the

continued significant ownership interests of the existing stockholders, no adjustments have been made to the historical carrying amounts of the Company's assets and liabilities as a result of the Transaction.

In November 1999, the Company consummated an initial public offering of its common stock. A total of 12,765,000 shares were issued in connection with the offering resulting in net proceeds after underwriters' discount and expenses of approximately \$118.1 million. In addition, concurrent with the offering, all outstanding preferred stock and related accrued cumulative dividends were converted into 5,040,868 shares of the Company's common stock.

ITEM 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Concentration of Customers and Suppliers

The relative concentrations of customers and suppliers of the Company are:

	1997	1998	1999
Revenues (percent of revenues):			
Incumbent Local Exchange Carriers (ILECs, see Note 5)	37%	37%	58%
Suppliers (percent of operating costs):			
largest supplier	44%	50%	49%

In 1997, 1998 and 1999, the Company's largest supplier was also the largest ILEC.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates.

Regulation and Competition

Rates charged by the Company for certain telephone services are subject to the approval of various regulatory authorities. Trends in the telecommunications industry point toward increased competition in virtually all markets and the continued deregulation or alternative regulation of telecommunications services in many jurisdictions.

Revenue Recognition

Revenues from the sale of telecommunications products are recognized in the month in which the service is provided, except for reciprocal compensation generated by calls placed to ISPs connected through the Company's network.

NOTES TO FINANCIAL STATEMENTS

The rights of competitive local exchange carriers, such as the Company, to receive this type of compensation is the subject of numerous regulatory and legal challenges (see Note 5). Until this issue is ultimately resolved, the Company will continue to recognize this revenue on a cash-received basis.

Revenues from the sale of telecommunications products are recognized upon installation, or if no installation is required, upon shipment. Initial non-recurring revenues from the installation of telecommunication products are recognized upon completion of installation to the extent of direct costs incurred. Any initial non-recurring installation revenue in excess of direct costs is deferred and amortized over the expected service contract period, generally two years or less.

Cash Equivalents

For purposes of reporting cash flows, the Company considers all highly liquid investments with an original maturity of three months or less from the date of acquisition to be cash equivalents.

Restricted Cash

Restricted cash represents short-term investments deposited in an interest reserve trust account to fund the initial interest payments through February 1, 2000 under the \$150,000,000 Senior Notes. All such interest payments have been made.

Short-Term Investments

All investments with an original maturity of greater than three months from the date of acquisition are accounted for under Financial Accounting Standards Board (FASB) Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities." The Company determines the appropriate classification at the time of purchase. All investments as of December 31, 1999 were classified as available-for-sale and appropriately carried at fair value. Realized gains and losses are included in other income, net in the accompanying statements of operations. Differences between cost and fair value are recorded as unrealized gains and losses in a separate component of stockholders' equity. As of December 31, 1999, the cost of these investments approximated market.

Inventories

Inventories consist of telephone equipment, parts and installation materials, which are valued at the lower of cost or market. Cost is determined by the average cost method. Provision is made to reduce slow moving inventory to reflect its estimated net realizable value.

Equipment, Vehicles and Leasehold Improvements

Equipment, vehicles and leasehold improvements are stated at cost and include network and other communication equipment, office furniture and equipment, vehicles, leasehold improvements, projects in progress and equipment deposits. Equipment includes assets acquired under capital leases. Expenditures for maintenance are charged to expense as incurred. Upon retirement, the asset cost and related accumulated depreciation are relieved from the financial statements. Gains and losses associated with dispositions of equipment, vehicles and leasehold improvements are reflected as a component of other income, net in the accompanying statements of operations. Depreciation and amortization is computed using the straight-line method based on the following estimated useful lives:

Equipment	3 to 7 years
Vehicles	5 years
Leasehold improvements	10 years or life of lease, whichever is shorter

The Company capitalizes interest on capital projects when the project involves considerable time and major expenditures. Such interest is capitalized as part of the cost of the equipment and leasehold improvement and is amortized over the remaining life of the assets. Interest is capitalized based on rates for borrowings that are outstanding over the period required to complete the asset. In 1998 and 1999, the Company capitalized \$303,000 and \$2,346,000, respectively, of interest related to capital projects. Capitalizable interest in 1997 was insignificant.

Depreciation and amortization of equipment, vehicles and leasehold improvements was \$2,204,000, \$4,106,000 and \$8,475,000 for the years ended December 31, 1997, 1998 and 1999, respectively.

Included in projects in progress at December 31, 1998 is \$20,828,000 for deposits paid or payable on equipment not in service at year-end.

Deferred Financing Costs, Net

Deferred financing costs, net consist primarily of capitalized amounts for underwriter fees, professional fees and other expenses related to the issuance and subsequent registration of the \$150,000,000 Senior Notes. These deferred financing costs are being amortized on a straight-line basis (which approximates the effective interest method) over the estimated 10 year term of the notes beginning January 29, 1999. Other deferred financing costs are for the senior notes exchange offering and costs relating to the senior credit facility. Amortization expense

NOTES TO FINANCIAL STATEMENTS

for the years ended December 31, 1998 and 1999, was \$1,438,000 and \$1,162,000, respectively, and is included within interest expense in the accompanying statements of operations.

Other Assets

At December 31, other assets consist of the following:

	1998	1999
Deferred financing costs	\$ 1,195,000	\$ 5,648,000
Acquisition of lease rights	—	1,513,000
Long-term portion of prepaid expenses and deposits	—	849,000
Long-term portion of covenant not to compete	150,000	—
Other	44,000	209,000
	<u>\$ 1,389,000</u>	<u>\$ 8,219,000</u>

During 1999, the Company purchased lease rights of additional space in its Los Angeles facility. This amount is included in other assets as listed above and is being amortized over the life of the lease.

Other Accrued Liabilities

Other accrued liabilities include approximately \$1,018,000 and \$397,000 as of December 31, 1998 and 1999, respectively, of amounts collected from customers for taxes due to various governmental and regulatory authorities.

Supplemental Statements of Cash Flows Information

	1997	1998	1999
Cash paid during the period for:			
Interest (net of amount capitalized)	\$ 924,000	\$ 2,565,000	\$ 8,723,000
Income taxes (net of refunds)	2,351,000	2,195,000	4,499,000
Supplemental disclosure of noncash transactions:			
Acquisition of fixed assets using capital lease obligations	4,781,000	290,000	—
Issuance of the Preferred Stock in conjunction with the Transaction	—	13,156,000	—
Refinancing of capital lease obligation with note payable	—	1,599,000	—

Income Taxes

The Company provides for income taxes in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, "Accounting for Income Taxes." SFAS No. 109

requires the asset and liability method of accounting for income taxes. Under this method, deferred income taxes are recognized for the tax consequences of "temporary differences" by applying the applicable statutory tax rate to the differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities. Under SFAS No. 109, the effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date based on the applicable tax rate.

Other Comprehensive Income

In September 1997, the FASB issued SFAS No. 130, "Reporting Comprehensive Income." SFAS No. 130 establishes the disclosure requirements for comprehensive income and its components within the financial statements. There were no items of other comprehensive income for the years ended December 31, 1997, 1998 and 1999; therefore, comprehensive income is the same as net income (loss) for each of these years.

Segment Reporting

The Company has adopted Statement of Financial Accounting Standards (SFAS) No. 131, "Disclosures about Segments of an Enterprise and Related Information." As an integrated telecommunications provider, the Company has one reportable operating segment. While the Company's chief decision-maker monitors the revenue streams of various services, operations are managed and financial performance is evaluated based upon the delivery of multiple services over common networks and facilities. This allows the Company to leverage its costs in an effort to maximize return. As a result, there are many shared expenses generated by the various revenue streams; because management believes that any allocation of the expenses to multiple revenue streams would be impractical and arbitrary, management does not currently make such allocations internally. The chief decision-maker does, however, monitor revenue streams at a more detailed level than those depicted in the Company's historical general purpose financial statements.

Specifically, the following table presents revenues by service type:

	1997	1998	1999
Local services	\$ 17,810,000	\$ 28,147,000	\$ 79,071,000
Long distance services	5,133,000	6,328,000	7,974,000
Dedicated transport services	3,312,000	4,155,000	5,162,000
Products and services	2,073,000	2,104,000	1,485,000
Other	1,223,000	1,477,000	1,813,000
	<u>\$ 29,551,000</u>	<u>\$ 42,211,000</u>	<u>\$ 95,505,000</u>

Local services revenues for the year ended December 31, 1999 include \$26,308,000 of reciprocal compensation settlement payments (Note 5).

NOTES TO FINANCIAL STATEMENTS

Other Recent Pronouncements

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and for Hedging Activities," effective for fiscal years beginning after June 15, 1999. Management does not expect adoption of SFAS No. 133 in future periods to have a significant impact on the Company's financial statements.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 ("SAB 101"), Revenue Recognition in Financial Statements. SAB 101 provides guidance on applying generally accepted accounting principles to revenue recognition in financial statements, and is effective for us in the second quarter of 2000. While we believe that SAB 101 will have no material effect on our current accounting policies, we will evaluate our current policies to ensure that they are in accordance with SAB 101.

Income (Loss) Per Share

Income (loss) per share has been calculated under SFAS No. 128, "Earnings per Share." SFAS No. 128 requires companies to compute income (loss) per share under two methods (basic and diluted). Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average shares of common stock outstanding during the period. Diluted net income (loss) per share information considers the effect of dilutive securities (stock options and convertible preferred stock) as follows:

	For the Year Ended December 31, 1999		
	Income	Shares	Per Share
Basic net income per share:			
Net income applicable to common stockholders	\$11,821,000	20,172,968	\$ 0.59
Effect of dilutive securities:			
Convertible redeemable preferred stock	—	—	
Stock options	—	1,120,860	
Diluted net income per share:			
Income available to common stockholders and assumed conversions	\$11,821,000	21,293,828	\$ 0.56

Conversion of the convertible redeemable preferred stock for the years ended December 31, 1998 and 1999 and the effect of the exercise of stock options for year ended December 31, 1998 are antidilutive and have been excluded from the calculation of diluted income (loss) per share. The Company consummated an initial public offering of its common stock and converted all outstanding convertible redeemable preferred stock in November 1999 (see Note 1).

Basic and diluted income per share was the same for the year ended December 31, 1997 as there were no convertible preferred stock or stock options outstanding during 1997.

The Company evaluated the requirements of the Securities and Exchange Commission Staff Accounting Bulletin (SAB) No. 98 and concluded that there are no nominal issuances of common stock or potential common stock that would be required to be shown as outstanding for all periods presented herein as outlined in SAB No. 98.

3. LONG-TERM DEBT AND OTHER LONG-TERM OBLIGATIONS:

Long-term debt and other long-term obligations consisted of the following at December 31, 1998 and 1999:

	1998	1999
Senior Notes	\$ —	\$150,000,000
Senior secured borrowings and other long-term obligations	100,000,000	—
Notes payable, less current portion	116,000	17,000
	<u>\$100,116,000</u>	<u>\$150,017,000</u>

On January 29, 1999, the Company issued \$150,000,000 of Senior Notes at par. The Senior Notes bear interest at 13.5 percent payable in semiannual installments, with principal due on February 1, 2009.

Proceeds of the Senior Notes were used to repay \$100,000,000 of senior secured borrowings (including \$9,000,000 of other long-term obligations subsequently financed through senior secured borrowings) and to establish an interest reserve account to cover initial interest payments due under the Senior Notes through February 1, 2000.

The Senior Notes carry provisions that allow the Company, at its option, to (i) redeem up to 35 percent of the notes with proceeds of certain public offerings of equity prior to February 1, 2002, (ii) redeem all or part of the notes at specified prices on or after February 1, 2004, or (iii) offer to exchange the notes within 180 days from the issue date for a new issue of identical debt securities registered under the Securities Act of 1933, as amended (the Securities Act). In August 1999, the Company completed the registration of these notes under the Securities Act and on September 22, 1999 all of the unregistered Senior Notes were exchanged for Senior Notes registered under the Securities Act of 1933.

The basic covenants of these notes restrict (subject to certain limitations) the Company's future ability to pay

NOTES TO FINANCIAL STATEMENTS

dividends, repurchase stock, pledge or sell assets as security for other transactions, or engage in mergers and business combinations. The covenants allow the Company to incur additional debt subject to various limitations.

The Company has a three-year senior credit facility expiring June 15, 2002 that provides for maximum borrowings of \$40 million to finance working capital, the cost of the Company's planned capital expansion and other corporate transactions. The borrowings are secured by substantially all of the Company's assets. Borrowings under this senior credit facility will bear interest, at the Company's option, at (1) the Base Rate (as defined) or (2) the LIBOR Rate (as defined) plus between 2.25 percent and 3.5 percent. As of December 31, 1999, there were no amounts outstanding under this facility and the borrowing rate would have been 9.25 percent. The credit facility requires the Company to meet certain financial tests, including, without limitation, maximum levels of debt as a ratio of earnings before interest, taxes, depreciation and amortization (as defined), minimum interest coverage and maximum amount of capital expenditures. The credit facility contains certain covenants which, among other things limit the incurrence of additional indebtedness, investments, dividends, transactions with affiliates, asset sales, acquisitions, mergers and consolidations, prepayments of other indebtedness (including the Senior Notes), liens and encumbrances and other matters customarily restricted in such agreements, unless specific consent is obtained.

At December 31, 1998 and 1999, notes payable consisted of contracts payable to banks and finance companies for vehicles, requiring monthly principal and interest payments of \$602 to \$1,510 at interest rates from 0.9 percent to 8.2 percent due through June 2001. Notes payable are secured by Company owned vehicles. Future principal payments consist of \$99,000 and \$17,000 in 2000 and 2001, respectively.

4. EXTRAORDINARY ITEM—LOSS ON EARLY EXTINGUISHMENT OF DEBT:

In conjunction with the Transaction [see Note 1] and the receipt of the senior secured borrowings during 1998, as discussed in Note 3, the Company repaid certain amounts outstanding under notes payable and capital leases for equipment. The resulting loss in 1998 from the early extinguishment of the debt of \$695,000, less the applicable income tax benefit of \$278,000, has been reflected as an extraordinary item in the accompanying statements of operations for the year ended December 31, 1998.

5. COMMITMENTS AND CONTINGENCIES:

Leases

The Company leases its five principal facilities in Stockton, Oakland, Los Angeles, Las Vegas and Seattle pursuant to noncancellable operating leases that expire in June 2002, November 2003, September 2006, August 2009 and December 2009, respectively. The lease expiring in June 2002 also contains five two-year renewal options. The leases expiring in November 2003, September 2006, August 2009 and December 2009 also contain two five-year renewal options. The Company also leases telephone equipment sites and telephone circuits on month-to-month, annual and long-term noncancellable leases. Management of the Company expects that these leases will be renewed or replaced by other leases in the normal course of business.

The Company's future minimum lease payments with initial terms in excess of one year as of December 31, 1999, are as follows:

	Operating Leases	
	Space	Telephone Circuits and Equipment
2000	\$ 1,650,000	\$ 6,894,000
2001	1,584,000	6,535,000
2002	1,400,000	4,805,000
2003	1,113,000	3,105,000
2004	1,043,000	1,462,000
2005 and thereafter	3,362,000	—
	<u>\$10,152,000</u>	<u>\$22,801,000</u>

Rental expense charged to operations for the years ended December 31, 1997, 1998 and 1999, for all operating leases for space was \$432,000, \$650,000 and \$1,260,000, respectively, and is included in selling, general and administrative expense in the accompanying statements of operations. Rental expense charged to operations for telephone circuits of approximately \$6,000,000, \$9,935,000 and \$12,729,000 for the years ended December 31, 1997, 1998 and 1999, respectively, is included in operating costs in the accompanying statements of operations.

Rental expense paid to related parties was approximately \$ -0-, \$35,000 and \$163,000 for the years ended December 31, 1997, 1998 and 1999, respectively.

Purchase Commitments

At December 31, 1999, the Company has approximately \$19,000,000 of purchase orders outstanding for network equipment due for delivery during 2000. These purchase

NOTES TO FINANCIAL STATEMENTS

orders are cancelable up to 60 days prior to delivery without penalty and are expected to be financed from the proceeds received from the Senior Notes, from internally generated cash flows, from borrowings under the senior credit facility or from proceeds from the Company's initial public offering consummated November 9, 1999.

In addition, the Company is in the process of implementing a new billing and operations support system. Total estimated costs for this system aggregate approximately \$16,500,000 of which approximately \$9,000,000 was incurred in 1999, \$6,000,000 is estimated to be incurred in 2000 and \$1,500,000 in 2001. All of the amounts incurred in 1999 are recorded in projects in progress at December 31, 1999.

During 1998 and 1999, the Company purchased approximately 50 percent and 56 percent, respectively, of total fixed assets from a single vendor.

Employment Agreements

The Company has entered into employment agreements with certain key executives that provide for minimum annual base salaries, bonus entitlements upon the achievement of certain objectives, and the issuance of stock options.

These employment agreements, which were approved by the Company's stockholders in 1998 in connection with the Transaction (see Note 1), granted options to two executives to purchase up to 568,750 shares of the Company's common stock. The exercise price of these options of \$0.48 per share approximated the fair market value of the Company's common stock at the date of grant. These options vest over various dates through October 2001 and expire at various dates through October 2008 (see Note 6).

The employment agreements were effective as of or subsequent to the close of the Transaction and have terms varying from one to three years; however, they may be terminated by either party at an earlier date under certain circumstances. As of December 31, 1998 and 1999, the Company accrued approximately \$304,000 and \$811,000 in accrued payroll and related expenses in the accompanying balance sheets for bonuses payable under these agreements.

Revenue Recognition and Legal Proceedings

The Company has established interconnection agreements with certain Incumbent Local Exchange Carriers (ILECs). The Telecommunications Act of 1996 requires ILECs to enter into interconnection agreements with Competitive Local Exchange Companies (CLECs, such as the

Company) and other competitors and requires state Public Utilities Commissions (PUCs) to arbitrate such agreements.

The interconnection agreements outline, among other items, compensation arrangements for calls originating or terminating in the other party's switching equipment, payment terms, and level of services.

Various ILECs have disputed, and are continuing to dispute, that internet traffic calls made to an ISP are not local calls, and as such are not covered by the interconnection agreements. Further, two ILECs with which the Company has interconnection agreements had withheld payments from amounts billed by the Company under their agreements since August 1997, and have filed complaints with the Superior Court of the State of California and the California and Nevada Public Utility Commissions (PUC's). The Superior Court ordered the complaint stayed pending the California PUC's review of the issues raised by the complaint.

In February 1999, the Federal Communications Commission (FCC) issued a Declaratory Ruling on the issue of reciprocal compensation for calls bound to ISPs. The FCC ruled that the calls are jurisdictionally interstate calls. The FCC, however, determined that this issue did not resolve the question of whether reciprocal compensation is owed. The FCC noted a number of factors that would allow the state PUCs to leave their decisions requiring the payment of compensation undisturbed.

On June 24, 1999, the California PUC adopted a decision in the arbitration proceeding between the Company and Pacific Bell which held that reciprocal compensation would be payable for ISP calls under the new interconnection agreement with Pacific Bell which became effective on June 29, 1999. Pacific Bell has requested a rehearing of the decision, although Pacific Bell has paid the full amount of billings for calls since the effective date of the new agreement.

On September 9, 1999, the Company entered into a settlement agreement with Pacific Bell regarding its claims for unpaid reciprocal compensation under their prior interconnection agreement. Under the terms of the settlement agreement, Pacific Bell agreed to pay \$20.0 million to the Company and \$20.0 million to certain stockholders of the Company as of the date of the recapitalization (see Note 1), in settlement of those claims. As a result of these payments, the terms of the September 1998 recapitalization requiring additional distribution to certain shareholders have been satisfied.

On September 2, 1999, Nevada Bell named the Company and others as defendants in a suit to reverse the decision

NOTES TO FINANCIAL STATEMENTS

of the Public Utilities Commission of Nevada. The Company is contesting the claims of Nevada Bell and no assurances can be given concerning the outcome of this case or any resulting appeal.

On August 25, 1999, the Company along with the commissioners of the California Public Utilities Commission and others, were named as a defendant in an action filed by GTE California (GTE). The action challenges the legality of the California Public Utilities Commission's decision regarding requiring reciprocal compensation for traffic termination to ISPs. GTE argues that such calls to ISPs are not local calls within the meaning of its agreement with the Company even though they are dialed and billed as local calls. The Company is contesting the claims of GTE.

In October 1999, GTE paid, and the Company recorded as revenue, \$6,308,000 of reciprocal compensation that GTE had previously withheld. GTE has not waived its rights to appeal, contest and seek subsequent reimbursements of amounts paid for reciprocal compensation.

In February 2000, the California Public Utilities Commission commenced a separate generic proceeding to develop its policy regarding reciprocal compensation.

The Company cannot predict the impact of the FCC's ruling on existing state decisions or the outcome of pending appeals or on additional cases in this matter. Given the uncertainty concerning the final outcome of the PUC proceedings, the possibility of future extended appeals or additional litigation, and future decisions by the FCC, the Company continues to record the revenue associated with reciprocal compensation billings to ILECs on a cash-received basis.

The amounts withheld by the two ILECs which had withheld payments from amounts billed by the Company under their agreements during the years ended December 31, 1997, 1998 and 1999 are as follows:

	1997	1998	1999
Total amount billed to specified ILECs during the year	\$14,858,000	\$48,264,000	\$58,866,000
Amount withheld by specified ILECs and not recorded as revenue in the Company's statements of operations	(3,793,000)	(32,845,000)	(29,855,000)
Amounts received for prior withholding and recorded as revenue	—	254,000	26,308,000
Net amount recorded as revenue from the specified ILECs during the year	\$11,065,000	\$15,673,000	\$55,319,000

6. STOCKHOLDERS' EQUITY:

Common Stock

In connection with the transactions in September 1998, certain stockholders of the Company entered into a Registration Agreement, whereby at any time prior to September 26, 2001, one of the stockholders of the Company may request that the Company grant holders of the common stock of that stockholder the right to purchase a certain number of shares of the Company's common stock (the "Rights Offering"). The Rights Offering, covering 924,165 shares offered from the stockholder to its shareholders, was consummated in connection with the initial public offering of the Company's common stock in November 1999. Following 180 days after the Rights Offering, subject to certain limitations, stockholders of the Company who are party to the Registration Agreement may request that the Company register all or any portion of such stockholder's common stock in the Company with the Securities and Exchange Commission (SEC). In addition, the Registration Agreement provides that, subject to certain limitations, the parties to the Registration Agreement and certain transferors of common stock originally issued to the parties of the Registration Agreement may request that the Company include any common stock held by such persons or entities with any of the Company's common stock that the Company proposes to register.

Stock Split

On March 19, 1999, the Board of Directors authorized a ten-for-one split of the Company's authorized and outstanding common stock and preferred stock. On October 7, 1999, the Board of Directors authorized a 1.4 for 1 split of the Company's outstanding common and preferred stock. In addition, on October 7, 1999, the Board of Directors approved a resolution to increase the authorized shares of common stock to 50,000,000 shares. All share and per share data have been restated to reflect these stock splits.

Convertible Redeemable Preferred Stock

The preferred stock has preference over common stock in liquidation equal to its liquidation value of \$25.72 per share, plus accrued dividends computed at a 10 percent rate, compounded quarterly (collectively, the Preference Amount). After payment of the Preference Amount, the preferred stock and the common stock share ratably in any distributions by the Company. As of the date of the initial public offering in November 1999, all of the outstanding preferred stock and cumulative dividends then outstanding were converted into common stock.

NOTES TO FINANCIAL STATEMENTS

Stock Options

In January 1999, the Company's Board of Directors approved the terms of the 1999 Stock Incentive Plan (the "Plan") which authorizes the granting of stock options, including restricted stock, stock appreciation rights, dividend equivalent rights, performance units, performance

shares or other similar rights or benefits to employees, directors, consultants and advisors. Options granted under the Plan have a term of ten years. In addition, options have been granted to two senior officers outside of the 1999 Plan but governed by the rules of the 1999 plan. An aggregate of 3,150,000 shares of common stock have been reserved for option grants.

A summary of the status of the Company's stock options plan at December 31, 1999 and changes during the years ended December 31, 1998 and 1999 are presented in the table below:

	Qualifying	Nonqualifying	Total	Weighted Average Exercise Price	Weighted Average Fair Value Of Options Granted
Balance, December 31, 1997	—	—	—	—	
Granted	—	568,750	568,750	\$ 0.48	\$ 0.08
Balance, December 31, 1998	—	568,750	568,750	0.48	
Granted	1,325,865	366,335	1,692,200	5.06	3.00
Cancelled	(36,300)	—	(36,300)	2.57	
Balance, December 31, 1999	1,289,565	935,085	2,224,650	\$ 3.93	

Options outstanding, exercisable and vested by price range at December 31, 1999 are as follows:

Range of Exercise Price	Number Outstanding	Weighted Average Contractual Life	Number Vested and Exercisable
\$ 0.48	568,750	8.8	422,917
2.14	1,215,900	9.3	—
10.00	319,000	9.8	224,000
22.06	121,000	9.9	—
	<u>2,224,650</u>		<u>646,917</u>

The Company has adopted the disclosure-only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation." Had compensation expense for the Plan been determined based on the fair value at the grant dates, as prescribed in SFAS No. 123, the Company's earnings and earnings per share would have been as follows:

	1997	1998	1999
Net income (loss) attributable to common stockholders:			
As reported	\$ 4,495,000	\$ (1,991,000)	\$ 11,821,000
Pro forma	4,495,000	(2,020,000)	11,423,000
Basic earnings per common share			
As reported	\$ 32.11	\$ (0.38)	\$ 0.59
Pro forma	32.11	(0.38)	0.57
Diluted earnings per common share:			
As reported	\$ 32.11	\$ (0.38)	\$ 0.56
Pro forma	32.11	(0.38)	0.54

The fair value of each option was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions used for the grants: expected dividend yield of 0 percent in all periods; expected volatility of 74 percent for 1999 and 0 percent for 1997 and 1998; weighted average risk-free interest rates ranging from 4.9 percent to 6.17 percent for all periods presented in the table above; and expected lives of four years for all periods.

NOTES TO FINANCIAL STATEMENTS

7. INCOME TAXES:

The provision for income taxes consists of the following:

	1997	1998	1999
Current:			
Federal	\$ 1,783,000	\$ 353,000	\$ 6,795,000
State	503,000	245,000	—
Deferred:			
Federal	546,000	861,000	5,595,000
State	165,000	102,000	721,000
	<u>\$ 2,997,000</u>	<u>\$ 1,561,000</u>	<u>\$ 13,111,000</u>

The Company's provision for income tax differed from the amount computed by applying the statutory federal income tax rate to income before income taxes and extraordinary item, as follows:

	1997	Rate	1998	Rate	1999	Rate
Income tax determined by applying the statutory federal income tax rate to income before income taxes and extraordinary item	\$2,547,000	34.0%	\$ 446,000	34.0%	\$10,156,000	35.0%
State income taxes, net of federal income tax benefit	450,000	6.0	230,000	17.5	470,000	1.6
Federal income tax effect of nondeductible costs related to the Transaction (see Note 1)	—	—	885,000	67.6	—	—
Reciprocal compensation settlement	—	—	—	—	1,500,000	5.2
Changes in reserves	—	—	—	—	936,000	3.2
Other	—	—	—	—	49,000	0.2
Provision for income taxes	<u>\$ 2,997,000</u>	<u>40.0%</u>	<u>\$ 1,561,000</u>	<u>119.1%</u>	<u>\$ 13,111,000</u>	<u>45.2%</u>

The cumulative balance sheet effects of deferred tax items are:

	1997	1998	1999
Trade accounts receivable allowances	\$ 129,000	\$ 171,000	\$ 173,000
Vacation and other accrued expenses	26,000	76,000	130,000
Inventory reserves	46,000	46,000	95,000
Tax credits	—	876,000	151,000
State taxes	250,000	163,000	152,000
Deferred tax assets	<u>451,000</u>	<u>1,332,000</u>	<u>701,000</u>
Depreciation and amortization	(1,097,000)	(2,834,000)	(5,982,000)
Capitalized interest	—	(130,000)	(884,000)
Reciprocal compensation settlement	—	—	(980,000)
Other reserves	(128,000)	(105,000)	(908,000)
Deferred tax liabilities	<u>(1,225,000)</u>	<u>(3,069,000)</u>	<u>(8,754,000)</u>
Net deferred tax liability	<u>(774,000)</u>	<u>(1,737,000)</u>	<u>(8,053,000)</u>
Less: Amount classified as current deferred tax asset	160,000	151,000	580,000
Net noncurrent deferred tax liability	<u>\$ (934,000)</u>	<u>\$ (1,888,000)</u>	<u>\$ (8,633,000)</u>

Tax credits of \$876,000 and \$151,000, shown above, represent unused tax credits associated with the payment of Alternative Minimum Tax (AMT) as of December 31, 1998 and 1999, respectively. Such credits, which do not expire, may be used to offset future income taxes payable.

NOTES TO FINANCIAL STATEMENTS

8. RELATED-PARTY TRANSACTIONS:

Bay Alarm Company (Bay Alarm)

Bay Alarm (a stockholder of the Company) and its subsidiary, InReach Internet, LLC, are collectively one of the Company's largest customers of telephone network services, comprising approximately \$2,109,000, \$2,680,000 and \$2,667,000, or 7.1 percent, 6.3 percent and 2.8 percent, of the Company's revenues for the years ended December 31, 1997, 1998 and 1999, respectively. The Company also had amounts due from Bay Alarm at December 31, 1998 and 1999. These amounts are included in accounts receivable from related parties in the accompanying balance sheets.

Bay Alarm provides the Company with security monitoring services at its normal commercial rates. The Company has recorded \$48,000, \$58,000 and \$60,000 as selling, general and administrative expense for these services for the years ended December 31, 1997, 1998 and 1999, respectively.

As outlined in Note 5, the Company leases its facility in Oakland from Bay Alarm. In addition to rent paid under this lease, the company recorded selling, general and administrative expense of \$0, \$59,000 and \$35,000 for the years ended 1997, 1998 and 1999, respectively, for related utility charges. In May 1999, the Company restructured the agreement to allow for direct payments to the utility company.

Notes Receivable from Stockholder

In connection with the Transaction, a stockholder of the Company, who is also an officer, purchased 37,500 shares of common stock from the Company for \$250,000. The Company received \$50,000 in cash from the stockholder and entered into a note receivable for the remaining balance of \$200,000. Subsequent to the Transaction, another officer of the Company acquired 6,247 shares of common stock for \$42,000. The Company received \$9,000 in cash and entered into a note receivable for the remaining \$33,000 due from the officer. The notes accrue interest at 5.54 percent and 5.12 percent, respectively, compounded annually, with any unpaid accrued interest and principal due at the earlier of (1) the sale of the above stock with proceeds received first applied to unpaid interest, then to principal; (2) sale of the Company; (3) 60 days from the date the stockholder is no longer an employee of the Company or a subsidiary; or (4) September 16, 2003 and October 16, 2003, respectively.

9. RETIREMENT PLAN:

In October 1996, the Company adopted a 401(k) retirement plan (the Plan) for all full-time employees who have completed six months of service. The plan year is from January 1 to December 31, and the Company will contribute \$0.50 for every \$1.00 contributed by the employee, subject to the Company's contribution not exceeding 3 percent of the employee's salary. Participants become fully vested after six years of service, although they vest incrementally on an annual basis after two years of service and until the six-year period is completed. The Company recorded selling, general and administrative expense of \$63,000, \$58,000 and \$134,000 for the years ended December 31, 1997, 1998 and 1999, respectively, for the Company's matching contributions.

Employees of the Company previously contributing to the CalPage 401(k) retirement plan (with identical provisions to the Plan) were able to roll their accumulated benefits into the Plan at date of commencement (October 1, 1996), with all prior employer contributions becoming fully vested on the date of rollover.

10. SALE OF ANSWERING SERVICE DIVISION:

In March 1997, the Company sold the customer base and other assets of its answering service division for \$420,000, payable \$200,000 in cash and a promissory note of \$220,000. The promissory note was paid in October 1997 at a discount of \$18,000. The Company recognized a net gain of \$385,000 on the sale in the year ended December 31, 1997.

11. SUBSEQUENT EVENTS:

Effective January 1, 2000, the Company acquired the customer base and certain other assets of Napa Valley Telecom (Napa Telecom), a switch-based, long distance telecommunications company headquartered in Napa Valley, California. The total purchase price, which was paid in cash, was approximately \$4,000,000 plus additional payments not to exceed \$500,000 if certain revenue targets are met. In connection with this agreement, the Company granted certain key employees of Napa Telecom options to purchase the Company's common stock at its November 1999 initial public offering price of \$10. As a result, the Company will recognize deferred compensation of approximately \$900,000. This amount will be amortized as an operating expense over the four year vesting term.

NOTES TO FINANCIAL STATEMENTS

PacWest Telecomm, Inc.

Effective February 1, 2000, the Company acquired all of the outstanding stock of Installnet, Inc. (Installnet) and three other related companies headquartered in Southern California. Installnet is primarily in the business of telecommunications equipment installation. The total purchase price, which was paid in cash and stock, approximated \$14,000,000 plus additional payments not to exceed \$1,500,000, if certain revenue targets are met. In addition, the Company has granted options to certain Installnet employees to purchase an aggregate of 105,000 shares of the Company's common stock at the market price at the date of grant.

These acquisitions will be accounted for using the purchase method of accounting.